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Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY, AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,

Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,

Respondents.

On Writ of Certiorari to the Court of Appeals of Kentucky

AMICUS CURIAE BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE*[1]

The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 650 securities firms, banks, and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London, and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

SIFMA and its members are actively involved in all aspects of the municipal bond markets. Accordingly, SIFMA has a particular interest in the legal, regulatory and market practice issues raised in this case. Collectively, its membership accounts for approximately 90% of the nation's municipal bond underwriting and trading activity by volume, which represented an estimated $5 trillion in municipal bonds, including appropriation-backed bonds and other municipal securities, in 2006. SIFMA also has published a Standard Agreement Among Underwriters for use in municipal underwritings, as well as other standardized documentation for bond market transactions.

In view of the role of SIFMA's members in the underwriting, purchase, and sale of public debt by the States and their subdivisions, SIFMA has a strong interest in the constitutional question Petitioners raise regarding the

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[1] No counsel for any party authored this brief in whole or in part. Only the Securities Industry and Financial Markets Association and its members, through payment of their membership fees, made any monetary contribution to the preparation or submission of this brief. This brief is being filed with the consent of the parties.

treatment of municipal bonds under State tax laws. SIFMA submits this brief in support of Petitioners and to provide the Court with a practical understanding of the effect that a decision affirming the ruling of the Kentucky Court of Appeals would have on the municipal bond market.

STATEMENT OF THE CASE

Kentucky does not tax the interest earned by its residents on municipal bonds issued by the Commonwealth or its political subdivisions, but it does tax the interest earned by its residents on municipal bonds issued by other States and their political subdivisions. See Ky. Rev. Stat. Ann. § 141.010(9), (10).

Respondents are Kentucky residents who paid income tax on interest earned on obligations of States, and political subdivisions thereof, other than Kentucky. Respondents filed suit in the Jefferson County Circuit Court, claiming that Kentucky's income tax scheme violated the Commerce Clause of the United States Constitution by discriminating against the holders of obligations issued by sister States and/or their political subdivisions by imposing a tax on income earned on such obligations greater than that imposed upon interest earned on obligations of the Commonwealth. They sought declaratory and injunctive relief, as well as refunds for the taxes they paid.

The Jefferson Circuit Court granted summary judgment in favor of Petitioners and relied on the market participant doctrine in ruling that the Kentucky tax scheme does not violate the Commerce Clause. See, *e.g.*, *Reeves, Inc.* v. *Stake*, 447 U.S. 429 (1980); *Hughes* v. *Alexandria Scrap Corp.*, 426 U.S. 794 (1976). Specifically, the court found that "[w]hen a state issues municipal bonds, it participates in the bond market by supplying bonds in the market and paying interest on those bonds." Pet. App. at 18. Therefore, the court found, Kentucky "clearly may pay a higher rate of interest to resident

purchasers based upon theories of distributing state created benefits and market participation." *Id.*

Respondents appealed to the Kentucky Court of Appeals, which reversed, holding that "Kentucky's bond taxation system is facially unconstitutional as it obviously affords more favorable taxation treatment to in-state bonds than it does to extraterritorially issued bonds." Pet. App. at 6. Petitioners filed a motion for discretionary review of the Court of Appeals decision but the Kentucky Supreme Court denied the motion.

The Court granted a petition for certiorari on May 21, 2007.

SUMMARY OF THE ARGUMENT

In deciding this case, the Court should follow the reasoning set forth in its recent opinion in *United Haulers Association, Inc.* v. *Oneida-Herkimer Solid Waste Management Authority*, 127 S. Ct. 1786 (2007) (plurality opinion), where it held that a municipal trash flow control ordinance did not violate the dormant Commerce Clause because, although it granted a monopoly to a local trash processing facility to the exclusion of privately-owned trash processing facilities in other States, the ordinance was not discriminatory as it was designed to benefit a "clearly public facility, while treating all private companies exactly the same." *Id.* at 1795. *United Haulers* demonstrates that the dormant Commerce Clause was not intended to forbid statutes designed to protect a State's own public interests, even if an effect of such statutes comes at the expense of the interests of private market participants.

The Kentucky statute at issue here is even further removed from the purview of the Commerce Clause because it provides for preferential tax treatment of bonds issued by the State and its own municipalities over other States and their municipalities. Respondents do not claim that the Kentucky statute elevates private companies within Kentucky over private companies in other States; the statute simply prefers

one State's municipal bonds over another State's municipal bonds. That is, the statute benefits Kentucky governmental entities by giving its residents an incentive to purchase Kentucky State and local government bonds at lower interest rates than the same investors would require for purchase of the bonds of other States due to the differing tax treatments. Such conduct does not violate the Commerce Clause.

Stare decisis also strongly supports reversal of the court below. In *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881), the Court upheld a statute that allowed the State of Maryland to tax its residents on the registered public debt of *other* States, even where the debt was exempt from taxation by the debtor State, while not taxing public debt of Maryland. The Court held that there was "*no provision of the Constitution* of the United States which prohibits such taxation," *id.* at 594 (emphasis added), and "the States are left free to extend the comity which is sought, or not, as they please," *id.* at 595. The Court thus rejected the argument of petitioners that a constitutional prohibition was necessary to "avoid[] the danger of reciprocally hostile legislation by the several States against the credit of their neighbors." *Id.* at 594. *Stare decisis* counsels judicial respect for a court's earlier decisions and compels adherence to the long-standing precedent announced in *Bonaparte*. Adherence to precedent is especially warranted here, where the municipal bond market and the accompanying State tax laws have developed over several decades consistent with this century-old decision. Accordingly, the Court should reverse the decision of the court below.

An affirmance, on the other hand, may result in instability and price uncertainty in the national municipal bond market because forty-two other States have laws that, like Kentucky, treat bonds issued by other States less favorably from a tax standpoint than in-State bonds. States will be forced to overhaul their tax schemes by either exempting interest on all municipal bonds or taxing interest on all municipal bonds,

which in some States may require significant legislative or even state constitutional amendments. If the municipal bond tax incentive evaporates, the demand for such bonds may likewise vanish, thus drying up a major source of funding for State projects. Moreover, States – and possibly others – may face potential litigation.

Investors likewise may feel the effect of the unsettled market if the Court declares that the Kentucky tax scheme is unconstitutional. Investors may face price uncertainty on outstanding municipal bonds and potential litigation with market participants, at potentially significant expense, to recover taxes paid on extraterritorial bonds under a tax scheme that is deemed unconstitutional. If States opt to tax interest on all bonds, on the other hand, investors may encounter attempts by States to recover previously forgone tax revenues. Such a result would be particularly disruptive for investors who buy fixed-income, tax-advantaged bonds precisely for their predictable income streams, such as retirees.

Finally, the market as a whole likely will suffer through an initial period of "price discovery," during which issuers and other market participants may be unsure of demand for municipal bonds and may be forced to value bonds through trial and error. This market turmoil may force market makers to buy back municipal bonds, which may cause inventory to swell to unusually high levels, further depressing prices, until the full effect of the decision is absorbed.

ARGUMENT

I. THE COURT SHOULD REVERSE THE RULING OF THE KENTUCKY COURT OF APPEALS ON THE BASIS OF THE REASONING OF *UNITED HAULERS.*

The statute at issue here is similar to the ordinance recently upheld in *United Haulers Association, Inc.* v. *Oneida-*

Herkimer Solid Waste Authority, 127 S. Ct. 1786 (2007) (plurality opinion). In *United Haulers*, the Court held that a municipal trash "flow control" ordinance did not discriminate against interstate commerce because, although it required that trash haulers deliver trash to a processing plant owned and operated by the local government to the exclusion of privately owned trash processing facilities in other States, the ordinance "advance[d] a legitimate local purpose," *id.* at 1793, and benefited a "clearly public facility, while treating all private companies exactly the same," *id.* at 1795.

Although the ordinance in *United Haulers* is not identical to the Kentucky statute at issue here, the Court's reasoning compels the same result. The Court found that the flow control ordinance was not the kind of "economic protectionism" that the dormant Commerce Clause was intended to prevent. *Id.* at 1796 (quoting *Wyoming* v. *Oklahoma*, 502 U.S. 437, 454 (1992)). Indeed, the Court reasoned that "[l]aws *favoring local government*, by contrast, may be directed toward any number of legitimate goals unrelated to protectionism." *Id.* (emphasis added).

The Kentucky tax statute is even further removed from the type of "protectionist" legislation that the Constitution forbids than the flow control ordinance in *United Haulers*. In this case, Kentucky provides for preferential tax treatment of its own municipal bonds over the municipal bonds of other States. The Kentucky statute does not discriminate "in favor of *private* enterprise." *Id.* at 1794. Rather, Kentucky prefers its municipal bonds over those of other *States and municipalities*. As the Court noted in *United Haulers*, "States and municipalities are not private businesses – far from it." *Id.* at 1795. Unlike the private interests disfavored by the *United Haulers* flow control ordinance, States whose bonds receive less favorable tax treatment under the Kentucky statute are on equal footing with the Commonwealth of Kentucky. Any other State has the power to – and the vast majority of States, in fact, do – treat municipal bonds issued

within Kentucky the same way Kentucky treats bonds issued within those States, *i.e.*, by taxing their residents on interest earned on out-of-State bonds. So long as a State is not preferring one group of commercial interests over another group of commercial interests, "[t]he dormant Commerce Clause is not a roving license for federal courts" to mandate what conduct is appropriate for State and local governments. *Id.* at 1796. The Constitution simply was not intended to prevent States from preferring their own municipal bonds over the municipal bonds of other States. Accordingly, nothing in the Commerce Clause prohibits Kentucky's preferential tax treatment for municipal bonds issued in Kentucky.

To the extent the Commerce Clause applies at all, the Kentucky statute also satisfies the "burden" test of *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). The *Pike* test is reserved for statutes that serve legitimate local concerns and have nothing more than an incidental effect on interstate commerce. See *United Haulers*, 127 S. Ct. at 1797. Under the *Pike* test, the Court will uphold a statute like the Kentucky tax scheme "unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits." *Pike*, 397 U.S. at 142; see also *United Haulers*, 127 S. Ct. at 1797. The Kentucky tax statute clearly serves a legitimate – indeed, compelling – local concern: providing incentives to Kentucky's citizens to invest in the bonds that secure financing for local municipalities at lower interest rates. This financing, in turn, provides the citizens with the necessary infrastructure to ensure the community's health and welfare. State and local governments use the money generated by these bonds to support a broad array of traditional government activities, including education programs, health services, and public transportation systems. Bonds also help to fund specific projects, such as building new community facilities, expanding highways, and improving local security initiatives. Because any possible

burden imposed by the Kentucky tax scheme upon interstate commerce could not possibly outweigh the compelling public benefit it serves, it is unnecessary to determine whether the statute imposes any incidental burden on interstate commerce. *United Haulers*, 127 S. Ct. at 1797.

SIFMA recognizes that preferential tax policies nonetheless may raise Commerce Clause concerns regarding programs less central to public functions than the issuance of tax-advantaged public debt. Accordingly, SIFMA respectfully submits that the Court's decision should be narrowly limited to the context of tax preferences for municipal bonds, and should not prejudge discrimination in other areas that involve greater participation by private market participants. Such a limited ruling is consistent with the Court's longstanding tradition of deciding the case or constitutional issue before it on the narrowest ground available. See, *e.g.*, *Liverpool, N.Y. & Phila. S.S. Co.* v. *Emigration Comm'rs*, 113 U.S. 33, 39 (1885) (the Court shall not "formulate a rule of constitutional law broader than is required by the precise facts to which it is to be applied"); *Ashwander* v. *Tennessee Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring) ("The Court will not pass upon a constitutional question although properly presented by the record, if there is also present some other ground upon which the case may be disposed of.").

II. *STARE DECISIS* SUPPORTS REVERSAL.

The decision of the Kentucky Court of Appeals overturns a widespread network of statutes and governmental programs that have developed based on settled law since 1881. In *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881), the Court upheld a State's ability to tax interest earned on municipal bonds issued by other States. The tax scheme deemed constitutional in *Bonaparte* provided for the same disparate treatment allowed under the Kentucky statute.[2] The Court

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[2] The Maryland statute upheld in *Bonaparte* provided for taxation of interest on bonds issued by other States, but made no such provision for

considered "whether the registered public debt of one State, exempt from taxation by the debtor State, or actually taxed there, is taxable by another State when owned by a resident of the latter State." *Id.* at 594. The statute at issue in *Bonaparte* was challenged under both the Constitution as a whole (without expressly mentioning the Commerce Clause) and the Full Faith and Credit Clause. The challenge based on the Constitution as a whole was phrased in terms of the burden on other States and discrimination between the States. *See id.* (referring to petitioner's argument that the tax fosters "sectional jealousies and antagonisms" and "reciprocally hostile legislation by the several States against the credit of their neighbors"); Brief for Plaintiff in Error at 13, *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881) (No. 172) (referring to "harass[ing] and imped[ing] each other's administrative instrumentalities"). The Court ruled that "*no provision* of the Constitution . . . prohibits such taxation." *Bonaparte*, 104 U.S. at 594 (emphasis added). The Court explained that "the States are left free to extend the comity which is sought, or not, as they please." *Id.* at 595.

The Court should not lightly overturn 126 years of practice under *Bonaparte*. *Stare decisis* "commands judicial respect for a court's earlier decisions" and compels the Court to adhere to the long-standing precedent announced in *Bonaparte*. *Randall* v. *Sorrell*, 126 S. Ct. 2479, 2489 (2006) (plurality opinion) ("*Stare decisis* . . . avoids the instability

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bonds issued by the State of Maryland ("all bonds made by any corporation or ***by any other State***, or by any territory belonging to residents of this State . . . shall be liable to . . . taxation"). *See* Maryland Act of 1876, ch. 260, § 1 (quoted in Brief for Plaintiff in Error at 1-2, *Bonaparte* v. *Tax Court*, 104 U.S. 592 (1881) (No. 172) (emphasis added). Likewise, the Kentucky statute at issue here provides that "interest income derived from obligations of sister states and political subdivisions thereof," Ky. Rev. Stat. Ann. § 141.010(10)(c), must be added back to the gross income as defined by the federal tax code, which "does not include interest on any State or local bond," 26 U.S.C. §§ 61(a), 103(a) & (c)(1); 26 C.F.R. § 1.61-7(b).

and unfairness that accompany disruption of settled legal expectations."); see also *Itel Containers Int'l Corp.* v. *Huddleston*, 507 U.S. 60, 79 (1993) (Scalia, J., concurring) (the principal purposes of *stare decisis* are "to protect reliance interests and to foster stability in the law"). Indeed, adherence to precedent is the norm; departure from it is exceptional. See *Arizona* v. *Rumsey*, 467 U.S. 203, 212 (1984) (noting that departure from *stare decisis* requires "special justification"). *Stare decisis* applies to a decision's rationale, and not merely its narrowest "specific holding." See, *e.g.*, *Carey* v. *Musladin*, 127 S. Ct. 649, 655 (2006) (Stevens, J., concurring) (*stare decisis* includes "explanatory language" for the Court's ruling even if "such guidance . . . may not have been strictly necessary as an explanation of the Court's specific holding"); *Seminole Tribe* v. *Florida*, 517 U.S. 44, 67 (1996) ("When an opinion issues for the Court, it is not only the result but also those portions of the opinion necessary to that result by which we are bound."); *County of Allegheny* v. *ACLU*, 492 U.S. 573, 668 (1989) (Kennedy, J., concurring and dissenting) ("As a general rule, the principle of *stare decisis* directs us to adhere not only to the holdings of our prior cases, but also to their explications of the governing rules of law.").

In this case, adherence to precedent is especially warranted where the municipal bond market, and the accompanying State tax laws, have developed over many decades based on this century-old decision. Virtually every market participant is aware of the tax advantage approved in *Bonaparte*, as demonstrated by the more than 530 State-specific municipal bond funds currently available.[3] That this principle is considered settled law also may be seen in the offering documents delivered in connection with the issuance of tax exempt bonds. Each offering memorandum contains a tax

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[3] *See* Tom Herman, *Kentucky Suffers Setback in Muni-Bond Tax Case*, Wall Street J., Sept. 6, 2006, at D2.

section that describes the material tax consequences of owning such a bond. Until *certiorari* was granted in this case, the tax section in the majority of offering memoranda contained a simple statement, without reservation, that the interest on the bonds being issued is exempt from the income tax imposed by the issuing State.

Where, as here, the precedent "has engendered substantial reliance and has become part of the basic framework of a sizable industry," the Court should abide by the ruling in *Bonaparte* and uphold the Kentucky statute. *Quill Corp.* v. *North Dakota ex rel. Heitkamp*, 504 U.S. 298, 317 (1992); see also *Hilton* v. *South Carolina Pub. Rys. Comm'n*, 502 U.S. 197, 203 (1991) (declining to overrule worker compensation precedent where doing so "would require these States to reexamine their statutes, meanwhile putting at risk all employees and employers who have been acting on the assumption that they are protected in the event of injuries caused by an employer's negligence").[4]

III. AFFIRMING THE DECISION OF THE KENTUCKY COURT OF APPEALS MAY RESULT IN INSTABILITY AND PRICE UNCERTAINTY IN THE MUNICIPAL BOND MARKETS.

If the Court affirms the ruling of the Kentucky Court of Appeals, the extent of the effect on the municipal bond market will be unpredictable. The municipal bond market is enormous, as this form of public finance has been widely used in recent decades. As of first quarter 2007, there are approximately $2.5 trillion in State and local municipal bonds outstanding.[5] The size of this market can be demonstrated by

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[4] As above, *supra*, at 8, any ruling based on *stare decisis* should not address whether *Bonaparte* would apply to matters other than municipal bonds.

[5] *See* Federal Reserve, *Flow of Funds Accounts of the United States*, tbl.L.211, at 89 (June 7, 2007) *available at* http://www.federalreserve.gov/releases/Z1/.

the number of investors who filed tax returns reporting tax exempt interest on municipal bonds, which was roughly 4.4 million in 2004.[6] The Internal Revenue Service estimates that the interest earned on municipal bonds in that same year was $52 billion.[7]

Forty-two other States have laws that, like the Kentucky statute at issue here, give preferential tax treatment to in-State bonds over bonds issued by other States and their municipalities.[8] In particular, thirty-eight States currently impose income tax on interest earned on out-of-State bonds, while exempting from tax interest earned on in-State bonds.[9] Investors in municipal bonds rely on the preferential tax treatment given to in-State bonds; indeed, their tax advantage is a substantial selling point for such bonds. A decision that Kentucky's statute is unconstitutional may affect State budgets and tax schemes, cause confusion and uncertainty among investors, and lead to disruption in the municipal bond market.

Impact on the States

The impact of a change in the *status quo* would be borne significantly by the States. If the Kentucky statute is held to violate the Commerce Clause, a State that currently exempts interest earned on only its own municipal bonds will be compelled to comply with the Constitution by either

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[6] *See* Internal Revenue Service, SOI Tax Stats - Individual Statistical Tables by Size of Adjusted Gross Income (All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items) tbl.1.2 (2004), *available at* http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html (main page).

[7] *Id.*

[8] *See* Jerry Solomon & Hannah O'Brien-Rupert, Bear Stearns, *The Kentucky Department of Revenue* v. *Davis* 5 (June 22, 2007).

[9] *See* Petition for Cert. at 7-8, *Kentucky Dep't of Revenue* v. *Davis*, No. 06-666 (U.S. filed Nov. 9, 2006).

exempting interest on all municipal bonds, regardless of which State issued them, or taxing interest earned on all municipal bonds, including its own. Regardless of which approach a particular State adopts, the result will require significant changes to that State's tax program and may cause great disruption to its budgets.

If a State chooses to tax interest on all municipal bonds, it may even need to overhaul its governing laws. For example, California's Constitution provides a tax exemption for municipal bonds issued by the State or any local government within the State.[10] Accordingly, before it could impose a tax on interest earned on all municipal bonds, California would need to amend its Constitution. On the other hand, if a State chooses to exempt all municipal bond interest from taxation, the State may face tens of thousands of claims for refunds, based on taxes collected on interest income under what would have been determined to be an unconstitutional statute.

Another possible consequence that States will have to prepare for is the effect on demand for their municipal bonds. In financial markets, uncertainty typically causes investors to exit the market, and fewer investors may lead to higher issuance costs. A State that relies on municipal bonds as a major source of financing will need to anticipate whether the proposed change – either imposing a tax on its own municipal bonds or exempting all municipal bonds from tax – will increase or decrease demand for the bonds it issues. For instance, if a State chooses to exempt all municipal bonds from tax, that State's bonds may lose some of their appeal, relative to extraterritorial bonds, and extraterritorial bonds may become relatively more attractive. Conversely, if a State discontinues the exemption for interest on in-State municipal bonds, one would expect the reduced incentives to lead to a reduced pool of investors for those bonds and, consequently, the need to pay higher interest rates. Although demand from

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[10] Cal. Const. art. XIII, § 26.

State residents and non-residents eventually may reach an equilibrium, no one could possibly predict when that would happen, and States meanwhile would be forced to speculate about the revenue to be generated by their municipal bonds when planning their budgets.

Even if demand for a State's bonds remained constant, the effect on budgets from State to State would be unpredictable because the revenue generated by the bonds would depend largely upon the State's marginal tax rate. States with high marginal tax rates that opt to exempt interest on all municipal bonds likely would suffer a larger decrease in revenue than States with low marginal tax rates that, likewise, opt to exempt interest on all municipal bonds. For example, one group of commentators estimates that the revenue lost by New York State, if it opted to exempt interest on all municipal bonds, would be $45.8 million, while Oregon would lose as little as $8.5 million if it did the same.[11] Conversely, States with high marginal tax rates that choose to tax interest on all municipal bonds likely will experience a larger boost to revenue than States with lower marginal tax rates.

Impact on Investors

For the bondholders, these changes could mean many things. Under the current system in most States, investors have a tax incentive to buy municipal bonds issued by the State in which they live and are thereby encouraged to invest in capital improvement projects within their own States. If that incentive evaporates – because the States would be required to treat all municipal bonds equally – investors may forgo municipal bonds and seek, instead, higher-yielding corporate bonds. Investors who continue to trade in the

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[11] *See* Dwight Denison, Merl Hackbart, & Michael Moody, Inst. for Federalism & Intergovernmental Relations, Working Paper No. 2007-03, *Davis* v. *Department of Revenue of Kentucky: A Preliminary Impact Assessment* 14 (Oct. 20, 2006).

municipal bond market would face the consequences of the uncertainty caused by disruption of the status quo.

In addition to encountering volatility in the market, investors likely would face the potential for litigation with the dealers and/or the issuing municipalities. If the Court strikes down the existing Kentucky tax treatment of municipal bonds, the ruling necessarily would have retroactive application. See *Harper* v. *Virginia Dep't of Taxation*, 509 U.S. 86, 90 (1993) (requiring that courts give retroactive effect to rulings applied by the Court to the parties before it). As discussed above, to comply with the ruling, the States would be required to treat interest on all municipal bonds equally, regardless of the bonds' issuer. If a State opts to exempt interest on all municipal bonds, potentially huge classes of investors who paid taxes on extraterritorial bonds under the abolished tax schemes will seek refunds for those payments. Attempts to recover improperly collected taxes may require significant cost and effort by the investors, and may embroil the issuers and/or the dealers in extensive litigation.

This possible consequence is not necessarily avoided if States opt to abolish the exemption altogether because, in that case, investors potentially face attempts by States to recover the previously forgone tax revenues, and the bondholders would be prospectively subject to taxes that did not exist when they purchased the bonds. Investors no doubt would argue that when the State opted to tax previously tax-exempt municipal bonds, the State became liable for a breach of its obligations.[12] See *United States* v. *Winstar Corp.*, 518 U.S.

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[12] Currently, Minnesota is the only State with a preferential tax scheme similar to the Kentucky statute at issue that has provided for the contingency that a court may find its tax scheme unconstitutional. In 1995, Minnesota enacted legislation providing for taxation of all bonds, including its own otherwise tax-exempt bonds, in the event that its disparate tax treatment of municipal bonds is struck down. *See* Minn. Stat. § 289A.50(10). This provision may supply Minnesota municipal-

839 (1996) (plurality opinion). If the Winstar litigation and avalanche of related claims is any indication, suits over taxes assessed on previously tax-exempt bonds could consume the States and their budgets, as well as investors, in litigation for years to come. See, *e.g.*, Marcia Coyle, *Broken Promises May Bust Budget: S&L's High Court Victory in* 'Winstar' *Is Cited by Others to Demand Billions*, Nat'l L.J., Apr. 27, 1998, at A1.

Impact on the Market

As it currently stands, the municipal bond market is extremely efficient and provides excellent access to small issuers. If the status quo is disturbed, there are numerous possible consequences for the marketplace. Uncertainty has adverse effects on market prices and is thus disadvantageous to the municipal bond markets.

While market participants learn to navigate these new waters, the market may experience a period of what can be considered "price discovery." Issuers as well as broker-dealers may be unsure of the demand for all-taxable or all-exempt municipal bonds. As in any new market, they may be forced to determine how to value the bonds through trial and error. This price discovery period would last for an unknown period of time, during which issuers and broker-dealers would be forced to make quick price adjustments in response to demand. As a result, until a reasonable price is established, many investors may under- or overpay for municipal bonds, and States, in turn, may be shortchanged. Moreover, in light of the possible turmoil in the market, market makers may face a barrage of requests for bids on currently-held municipal bonds, but with all the uncertainty about how States are going to react, they would lack sufficient information to make a

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ities with a defense from some claims that they breached their obligations to investors because the post-legislation investors presumably were on notice of the possible tax consequences, but that does not mean that Minnesota municipalities would avoid litigation altogether.

reasonable bid. Market makers may be forced to buy back municipal bonds but may be unable to find a market for the bonds for quite some time, causing inventory to swell to unusual levels.

The valuation process of municipal bonds is already a complicated one, taking into consideration things like their typically low default rate, taxable rate (if any), and other factors specific to the issuing municipality. Requiring States to alter their tax treatment of municipal bonds by striking down the Kentucky statute would further complicate this process. It certainly would mean that market participants – the investors, the State, and/or the broker-dealers – will be hurt along the way, until the full effect of the States' reactions to a finding that the Kentucky statute is unconstitutional could be absorbed by the market.

CONCLUSION

For the foregoing reasons, SIFMA respectfully requests that the Court reverse the decision of the Kentucky Court of Appeals.

Respectfully submitted.

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